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client alert

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DEFAULT INTEREST UNDER ISDA AND FRENCH MASTER AGREEMENTS - LESSONS FROM THE LEHMAN "WATERFALL II" APPLICATION

INTRODUCTION

On 5 October 2016, Mr Justice Hildyard handed down his judgment in the third tranche of what has become known as the "Waterfall II Application" ("**Waterfall IIC**")[1]. Waterfall IIC was filed in the context of the administration of Lehman Brothers International (Europe) ("**LBIE**") by LBIE's administrators in order to obtain directions as to the allocation of the surplus remaining after the payment in full of the proved debts. The surplus amounted to around £7 billion and, inevitably given such a large amount, created grounds for litigation between competing creditors.

Waterfall IIC is of particular interest for the derivatives market as it addresses, in the context of debts proved in an administration, the default interest payable on "close-out" amounts arising after a termination of certain standard form master agreements for derivatives transactions governed variously by English, New York or German law (namely the 1992 and 2002 ISDA Master Agreements and the German Master Agreement).

Initially, Waterfall IIC was also intended to address similar issues arising from master agreements governed by French law, namely the FBF and AFB Master Agreements (for derivatives transactions), the AFTB Master Agreement (for repurchase transactions) and the AFTI Master Agreement (for securities lending transactions) (the "**French Law Issues**")[2]. However, parties to Waterfall IIC with competing interests eventually reached an agreement on the issues relating to the Euro denominated claims arising under the FBF and AFB Master Agreements (the "**Agreed Position**"[3]) and also agreed that the other issues relating to the AFTB Master Agreement and the AFTI Master Agreement did not need to be resolved in either the proceedings in the High Court or in the Agreed Position as they were *de minimis*. All French Law Issues were therefore removed from Waterfall IIC[4].

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[1] A copy of the judgment is available here.
[2] Issues 22 to 26 of Waterfall IIC.
[3] A copy of the Agreed Position is available here.
[4] Further to the pre-trial review held on 9 October 2015, the parties agreed, and Mr Justice Hildyard approved, in an order which was sealed on 30 October 2015 (the "**PTR Order**"), the removal of all French Law Issues from Waterfall IIC. A copy of the sealed PTR Order is available here.

This Client Alert focuses on the guidance on the construction of default interest provisions in standard form master agreements that can be drawn from the judgment rendered by the High Court (for the 1992 and 2002 ISDA Master Agreements) and the Agreed Position (for the FBF and AFB Master Agreements). It also incidentally addresses certain aspects of the default interest provisions in the AFTB and AFTI Master Agreements that can be inferred from the position papers and expert reports filed by the parties and their relevant experts in relation to the French Law Issues.

I. BACKGROUND: RULE 2.88 OF THE INSOLVENCY RULES 1986

In the context of an administration of the type applied to LBIE, Rule 2.88(7) of the Insolvency Rules 1986[5] provides that, if a surplus remains after the payment of the debts proved in the administration, such surplus shall, before being applied for any purpose, be applied in paying interest on those debts. Rule 2.88(9) further provides that such interest will be payable at whichever is the greater of (i) the rate specified in section 17 of the Judgments Act 1838 (which is 8 % for the period of LBIE's administration) and (ii) "*the rate applicable to the debt apart from the administration*".

In the case at hand, the "*rate applicable to the debt apart from the administration*" was the rate provided in the default interest provisions contained in the relevant master agreement, specifically:

- the "Default Rate" for the 1992 and 2002 ISDA Master Agreements;
- the default interest set out in clause 9.1 of the FBF Master Agreement and the AFB Master Agreement;
- the "Late Interest Rate" as defined in the AFTB Master Agreement; and
- the "Late Payment Interest" as defined in the AFTI Master Agreement.

Therefore, depending on the Court's interpretation of such provisions, LBIE's creditors would possibly be entitled to claim statutory interest at a rate higher than 8%, which would significantly increase the amount of the surplus to be allocated to the senior creditors and, as a consequence, substantially reduce the amount available for the subordinated creditors.

It is worth noting that under French law, interest is only payable by a party on a compounded basis if (i) it is expressly provided for in the applicable contract, and (ii) the interest has been due for at least a year[6], whereas under English law, contracting parties are free to agree whatever terms for the compounding of interest they choose. In practice, based on the drafting of the default interest provisions, and unless otherwise agreed in the schedule or annex to the relevant master agreement, interest will be paid at a daily compounding rate under the ISDA Master Agreement and the FBF and AFB Master Agreements (if due for over a year), but interest under the AFTB Master Agreement and AFTI Master Agreement will be paid on a simple or "flat-rate" basis.

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[5] Rule 2.88(7) of the Insolvency Rules 1986 : "*any surplus remaining after payment of the debts proved [in the administration] shall, before being applied for any purpose, be applied in paying interest on those debts in respect of the periods during which they have been outstanding since the relevant date [i.e. the date on which the company entered into administration]*".

[6] Article 1343-2 of the French Civil Code.

II. CONSTRUCTION AND EFFECT OF DEFAULT INTEREST PROVISIONS CONTAINED IN THE MASTER AGREEMENTS

The cost of funding under the ISDA Master Agreement is a borrowing cost only

The "Default Rate" in the ISDA Master Agreement is defined as "*the cost […] to the relevant payee […] if it were to fund or of funding the relevant amount*"[7]. Therefore the High Court had to consider the meaning of "cost of funding" and principally whether that language referred to a creditor's cost of borrowing only or if it could be interpreted more broadly to include all types of funding, and in particular equity funding.

This issue was of particular importance given its potential financial impact. As a matter of fact, were the "cost of funding" to include only the cost of borrowing, creditors would be less likely to be able to claim statutory interest at a rate higher than 8%. Conversely, were the "cost of funding" to extend to all types of funding, the rate could be higher, making it more likely for senior creditors to be able to claim statutory interest at a rate in excess of the 8% provided for in the Judgments Act 1838.

Mr Justice Hildyard concluded that for both the 1992 and the 2002 ISDA Master Agreements the "*cost […] to the relevant payee […] if it were to fund or of funding the relevant amount*" is to be certified by reference to the cost which the relevant payee is required to pay in borrowing the relevant amount (i.e. the close-out amount), whether an actual cost, where the relevant payee goes into the market to raise funds, or a hypothetical cost, where it does not do so. In other words, only the price paid for money borrowed, and neither the other ways of funding nor any other costs, would fall within the "cost of funding" language. In particular, Mr Justice Hildyard did not accept the argument that "*the phrase 'cost of funding' should be given its broad and natural meaning and should not be read down or restricted to exclude recovery of loss occasioned by or incidental to perfectly legitimate and commonly used methods adopted by many users of the ISDA Master Agreements to fund their businesses*", nor the argument that "*financial institutions have to maintain certain ratios of debt to equity*" and that the "*recourse to equity funding to fill a hole in its capital position caused by a default 'forms a key part of the factual matrix against which the definition must be construed'*". Mr Justice Hildyard also provided interesting additional guidance as to the way the cost of funding should be assessed or calculated[8].

Default interest provisions in the French Master Agreements

The question was different in respect of the FBF and AFB Master Agreements since the default interest provisions in clause 9.1 of the FBF and AFB Master Agreements do not refer to the "cost of funding" but to the "overnight refinancing rate"[9]. The only guidance that was provided on the interpretation of such terms came from the parties who agreed in the Agreed Position that it is "*a question of fact to be determined objectively and by reference to the relevant overnight refinancing rates which would have been offered to the original contracting party by market participants at the relevant time if not specified by the parties in the schedule to the relevant AFB or FBF master agreement or otherwise*". This is less detailed than the guidance

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[7] Section 14 of the 1992 and 2002 ISDA Master Agreements provides that the *"**Default Rate** means a rate per annum equal to the cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount plus 1% per annum".*

[8] See Answers to Issues 12 to 18 of Waterfall IIC.

[9] Clause 9.1 of the FBF and AFB Master Agreements provides that "*In the event of a delay in payment by one of the Parties of any amount due under the Agreement, such Party shall pay to the other default interest […] at the overnight refinancing rate of the Party entitled to receive the relevant amount, in the relevant Currency, plus one per cent. per annum. Interest shall be capitalised if due for a period in excess of a year*".

that can be drawn from the High Court's judgment in respect of the ISDA Master Agreement, but the stakes for the parties in respect of the French Master Agreements were not as substantial and, as such, the issue was not considered in the same level of detail.

As regards the AFTB and AFTI Master Agreements, the default interest provisions are drafted differently to those in the ISDA Master Agreement and the FBF and AFB Master Agreements, distinguishing between Euro and non-Euro denominated claims[10] (instead of providing a single rate applicable for all currencies). Whereas the default rate applicable to non-Euro denominated claims is defined rather broadly as "*the average of the overnight rates available to the beneficiary of the late payment*" (similar to the approach followed in the ISDA Master Agreement or the FBF and AFB Master Agreements), the default rate applicable to Euro denominated claims is a specifically identified rate (namely "*the highest rate charged by the European Central Bank for supplying liquidity to the beneficiary of the late payment*" for the AFTB Master Agreement and "*EONIA*" for the AFTI Master Agreement). If the default interest definition for Euro denominated claims removes scope for interpretation by using a designated rate, the more general definition for non-Euro denominated claims is still subject to interpretation as regrettably, no agreement was reached between the parties as to its exact meaning[11]. As a matter of fact, one could argue that those default interest provisions should be understood broadly to mean any "*overnight rate available to the beneficiary of the late payment*", whereas one could consider that the default rate is to be construed as the rate charged by the institution equivalent to the European Central Bank (for the AFTB Master Agreement) or the equivalent rate to EONIA (for the AFTI Master Agreement) for the applicable contractual currency.

III. THE RELEVANT "PAYEE"/"PARTY" IS LBIE'S ORIGINAL CONTRACTUAL COUNTERPARTY

The High Court also had to consider the identity of the relevant "party" or "payee" by reference to which the default interest rate was to be determined. This was of particular importance in the context of LBIE's administration as, in many cases, LBIE's counterparties had transferred their close-out amount claims to third party purchasers, and it is these third party purchasers that are claiming interest in LBIE's administration, in their capacity as assignees of such claims.

Consequently, the question that was debated at length in Waterfall IIC was whether the relevant "party" or "payee" following any assignment of such claims should be LBIE's original contractual counterparty or the third party to which such claim was transferred. The conclusion reached by the High Court for the 1992 and 2002 ISDA Master Agreements and by the parties in the Agreed Position for the FBF and AFB Master Agreements was that the relevant "party" or "payee" shall be LBIE's original contractual counterparty.

ISDA Master Agreements

Arguments put forward by the parties in respect of the ISDA Master Agreement were based primarily on grounds of construction and, for the party arguing that the cost of funding should always be determined by reference to the original contractual counterparty (regardless of the

[10] The AFTB Master Agreement provides that the Late Interest Rate is "*unless otherwise indicated (i) for Euro, the highest rate charged by the European Central Bank for supplying liquidity to the beneficiary of the late payment; and (ii) for any other Currencies, the average of the overnight rates available to the beneficiary of the late payment for the relevant period*" and the AFTI Master Agreement provides that the rate for calculating late payment interest is "*for Euro, EONIA for the relevant period, plus 1% per year and for other Currencies, the average of the overnight rates available to the beneficiary of the late payment for the relevant period, plus 1% per year*".

[11] The AFTB and AFTI Master Agreements were not part of the Agreed Position.

number of assignments), on the principle that the transferee cannot recover more than the original transferor could have recovered.

Mr Justice Hildyard concluded that the "relevant payee" in the 1992 and 2002 ISDA Master Agreements is LBIE's original contractual counterparty and not the third party to which LBIE's original counterparty transferred its interest in any of those close-out amounts. To illustrate this, Mr Justice Hildyard added figuratively that "*the transferee is entitled to the tree planted by the transferor and such fruit as had grown and would grow on it when transferred, and not to fruit of a different variety or quantity which might have grown had the transferee planted the tree*".

French Master Agreements

Arguments put forward by the parties on the French law side were slightly different, based primarily on the means of assignment effectively used for the transfer of the close-out amount (namely by way of a *cession de créance* (assignment of receivables) or by way of a *cession de contrat* (transfer of contract)) and the different legal regimes - and related consequences - in each case.

On the one hand, it was argued that, when a transfer of rights under an FBF or AFB Master Agreement from LBIE's original contractual counterparty to a third party has been effected by way of a *cession de contrat* (but not otherwise), the interest payable under clause 9.1 is calculated by reference to (i) the refinancing rate of the original contractual counterparty for the period before the date of the relevant transfer and (ii) the refinancing rate of the third party for any period thereafter. A different reasoning was followed for the AFTB Master Agreement and AFTI Master Agreement on the basis that the default interest provisions under such agreements were different, but still led to the same conclusion, i.e. that the default rate shall be determined by reference to the current transferee.

On the other hand, it was argued among other things that, as a matter of French law (and assuming implicitly that the transfer of the close-out amount was made pursuant to a *cession de créance*), the assignee of a claim cannot recover more from the debtor than the assignor could have recovered and accordingly the default interest rate to be payable under each of the FBF, AFB, AFTB and AFTI Master Agreements was to be calculated by reference to the relevant rates applicable to LBIE's original contractual counterparty.

In the Agreed Position, the parties contemplated both means of assignment (*cession de contrat* and *cession de créance*) and recognised that the two means may lead to different conclusions. However, the parties ultimately concluded that in these circumstances (the transfer of a close-out amount), a *cession de contrat* under French law would not be relevant, meaning that the way to transfer a close-out amount claim was by way of a *cession de créance*. As a result, the overnight refinancing rate referred to in the FBF and AFB Master Agreements (compounded annually if overdue for at least one year) was the rate applicable to LBIE's original contractual party, whether before or after the date of the relevant transfer.

No "agreed position" was reached by the parties on the issues arising from the AFTB and AFTI Master Agreements; however, given the similarity of contexts in which those provisions arise, logically, it would seem reasonable to infer that, notwithstanding the differences between the default interest provisions in the AFTB and AFTI Master Agreements and those in the FBF and AFB Master Agreements, the same conclusions as to the identity of the "relevant party" would apply.

CONCLUSION

The decision in Waterfall IIC provides welcome clarification for derivatives practitioners on the meaning of the “cost of funding” in the definition of the “Default Rate” in the ISDA Master Agreement, both in its 1992 and 2002 versions. In summary, default interest payable under an ISDA Master Agreement is to be calculated by reference to the cost of borrowing an amount equal to the close-out amount, such borrowing cost being that of the original contractual party, regardless of whether the close-out amount claim was subsequently assigned to a third party.

Although the parties reached the same conclusion as to the identity of the relevant “party” by reference to which the default interest provisions under the FBF and AFB Master Agreements should be determined, the Agreed Position did not provide the same level of guidance on the construction of such default interest provisions as the one provided by the High Court for the ISDA Master Agreement. In any event, parties may always reduce uncertainty by agreeing a specific default rate when negotiating the relevant annex to their master agreements. This is commonly the case for FBF Master Agreements where the parties generally elect in the annex the EONIA rate as the applicable “overnight refinancing rate” for the purpose of clause 9.1.

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